

**Arizona Department of Revenue (ADOR)
2019 Fiscal Analysis**

TITLE:

SB1460; Digital goods and services

EFFECTIVE DATE:

Applies to taxable periods from and after the first day of the month following the general effective date.

SUMMARY OF LEGISLATION:

The bill creates a new tax classification for pre-written computer software and digital goods (whether sold or rented), which follows the structure of the retail classification of the Arizona Transaction Privilege Tax (TPT). The bill allows for certain limited deductions that are currently allowed under the retail class and specifically limits the type of taxable transactions to only those specified under the new classification. The Department's analysis necessarily relies on ongoing conversations with affected stakeholders about the intent of the language. As acknowledged by other external fiscal analysts, the only way to estimate the fiscal impact is to make assumptions about interpretation and intent.

SCORING:

State Revenue Impact: (\$33.1) million reduction in state TPT revenue¹. The estimate is predicated on the methodology used by ADOR, which attempts to incorporate the intent of the bill as described by its proponents to the Department.

Administrative Complexity: **Medium - Utilizes existing ADOR processes and resources, but with required enhancements**

Substantive / Technical Issues: **High - The bill cannot be technically implemented without critical amendments being made**

ANALYSIS OF BILL BY SECTION:

See Attached Comparison chart

¹ See State Revenue Impact Section below for further detail.

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BACKGROUND/HISTORY:

A.R.S. § 42-5061 imposes the TPT under the retail classification. The retail classification is comprised of the business of selling tangible personal property (“TPP”) at retail. Arizona Revised Statutes (A.R.S.) § 42-5071 imposes the TPT on the business of leasing or renting TPP for a consideration. Critical to taxability under these two classifications is whether the item purchased or leased is TPP. A.R.S. § 42-5001(17) defines “tangible personal property” as “personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses.” In accordance with Arizona Courts, the Department has taken a broad view on the definition of TPP. It considers pre-written computer software and digital goods to be included in the definition of TPP. Thus, computer software and digital goods are taxable when sold or leased by taxpayers.

Please note the following for the lease or rental of TPP:

- For legal purposes, the licensing for use of TPP is different than a lease of TPP.
- Leases of TPP require exclusive possession or control; licensing for use does not require such exclusive possession or control, thus, a “license for use” of software for legal purposes is not taxable at the state level for rental TPT purposes, but is taxable at the municipal level.
- Industry use of the term “license for use” is not definitive and whether a lease of software is present is determined on a facts and circumstances basis.

Under the current statutory framework services (including digital) are not taxable. This includes situations where TPP is used in delivering a service but is not the main or dominant purpose. Whether TPP is used in delivering a service or whether the service is the main or dominant purpose is determined on a facts and circumstances basis.

Some taxpayers have challenged ADOR’s application of existing TPT statutes to a variety of digital products, contending that the Department has incorrectly categorized software and digital goods transactions as the sale or lease of tangible personal property. Instead, they argue that transactions involving software and digital goods should be categorized as nontaxable services. An ad hoc legislative committee held hearings on this issue in 2017 and legislation similar to this bill was run in 2018.

At this juncture, the Department is engaged in litigation with a handful of companies. **Table 1** contains a summary of the issues raised and the status of each case. Most cases have already been heard at the Office of Administrative Hearings (OAH).

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Table 1 **Current Litigation Concerning Digital Products**

Legal Issue(s) in Question	Status of the Litigation
Software hosted outside the State of Arizona	ADOR prevailed at OAH, case is now at Tax Court
Dedicated server space (rental of TPP) and Secure Socket Layer (SSL) certificates	ADOR prevailed at OAH, case is now at Tax Court
Streaming video (rental of TPP)	ADOR prevailed at OAH, case is now at Tax Court
Software hosted outside the State of Arizona	ADOR recently prevailed at OAH (28 February 2019)
Software hosted outside the State of Arizona	At OAH, unknown decision date

STATE REVENUE IMPACT:

(\$33.1) million General Fund revenue reduction, based on reduced TPT collections. Additionally, there is the potential for an indeterminate reduction in Corporate Income Tax - described below. The estimate is based on the methodology detailed below and the intent of the bill as described by its proponents.

Methodology

The Department relied on several sources of information to identify sellers of digital products². The first source used to guide the analysis is taxpayer self-identification on the ADOR TPT license application. Specifically, line 9 of the [Arizona Joint Tax Application](#) asks applicants to describe “merchandise sold or taxable activity.” The Department ran a query of its tax system, identifying taxpayers with business descriptions containing the following keywords in **Table 2**.

² The methodology used by ADOR focuses on actual reporting by taxpayers. There may be some sellers of digital products that have yet to license with the Department that will do if this bill becomes law. However, the amount of tax revenue such compliance will generate is indeterminate and likely small given the large number of businesses operating in the digital products space that already collect and remit tax in Arizona.

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Table 2**SEARCH TERMS**

Cloud	Internet Services
Data Processing	SAAS
Digital	Software Publish
Download	Software Service
Electronic Books	Web Hosting
Electronic Video	eBook

Based on the search terms, the Department then performed a query to catalog the taxpayers that self-identify as sellers of digital products covered by SB 1460. A manual review of the query results removed licensees with business descriptions that did not fall within the scope of the bill. In addition, the Department included in its analysis any other well-known sellers of digital products that did not self-identify using one of the search terms shown in **Table 2**, sellers that began collecting tax through a voluntary disclosure agreement in recent years, and any sellers that currently are protesting an ADOR assessment or denial of TPT refund.

Additionally, based on the information provided to the Department by external stakeholders, it is ADOR's understanding that taxable pre-written computer software is intended to have the following characteristics: 1) includes a "license"; 2) can be downloaded and/or retained in part or in all locally. By contrast, non-taxable SAAS has the following characteristics: 1) merely provides a customer "access" to the software; 2) the software is remotely accessed.

Having identified the universe of reporting taxpayers, the Department grouped them into six general categories and tallied the amount of TPT paid by licensees and distributed to the state. Critically, the Department then analyzed whether, under SB 1460, the categories created would be fully taxable, not taxable, or partially taxable (assigned a proportion between 0 and 1). The proportions are based on the Department's analysis of the bill, legislative intent - as described by the proponents of the bill - as well as examining the business models and product offerings of sellers that fall within the scope of this legislation. The results are displayed in **Table 3**. These proportions may be incorrectly estimated due to the lack of complete information about the specific scope of vendor activities within these aggregated categories. If the bill language is modified, actual proportions could be smaller than estimated.

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Table 3**GENERAL FUND IMPACTS**

Category	FY18 General Fund Estimate	Treatment Under SB 1460	Portion remaining Taxable	Portion No longer Taxable	FY20 State GF Revenue Impact	Description
Cloud	\$6,520,966	Some Taxable	0.20	0.80	(\$5,216,773)	Cloud storage & computing
Data Processing	\$3,014,745	exempt	0.00	1.00	(\$3,014,745)	Data processing, computing & storage
Digital Content	\$9,329,521	Some Taxable	0.85	0.15	(\$1,416,903)	Digital content for rent or purchase
Internet Products	\$9,002,466	exempt	0.00	1.00	(\$9,002,466)	Web hosting, teleconferencing, and related products
Other	\$11,807,976	Some Taxable	0.85	0.15	(\$1,771,196)	Digital products not captured elsewhere
Software Products	\$31,624,056	Some Taxable	0.60	0.40	(\$12,649,622)	Pre-written computer software and SAAS products
TOTAL	\$71,299,730				(\$33,071,706)	

Based on the methodology employed, the Department's point estimate of state TPT revenue loss is (\$33.1) million. The largest revenue loss by category is attributable to Software Products, which is also the category most sensitive to an increased revenue loss if the stated intent is not sufficiently reflected in the text of the bill and/or ADOR assumptions about the taxability of certain businesses' products is overstated.

Corporate Income Tax Impact

For Corporate Income Tax, any taxpayer whose digital product is treated as a service under this bill will cease sourcing receipts arising from sales/rentals of these products to Arizona for CIT purposes, resulting in a reduction in CIT revenue and an increase in refund requests for CIT paid in prior years. For CIT, sales of TPP are sourced to Arizona based on its sales to Arizona customers (a market-sourcing regime). For sales of services and intangibles, corporate receipts are only taxable in Arizona if: 1) the income producing activity is performed wholly in Arizona; or 2) the income-producing activity is performed both in and outside of Arizona and a greater proportion of the income-producing activity is performed in Arizona, relative to any other state, based on Arizona's Cost

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of Performance (COP)³ sourcing regime.

For many sellers of digital products, the COP occurs outside Arizona (e.g. California, New York, Texas, etc.). As such, if certain digital products are treated as services, those taxpayers will claim the COP occurs predominantly outside Arizona, reducing CIT collections. Several sellers of digital products have already filed refund claims or refuse to pay CIT to Arizona, arguing its digital product is a service, subject to the COP sourcing regime. Passage of this bill could increase the number of refund requests and decrease voluntary CIT collections. At this point, the estimated revenue loss is indeterminate.

³ Arizona is one of a rapidly decreasing number of states that use COP sourcing for sales of services and intangibles. For ease of tax administration, taxpayer compliance, and economic development purposes, nearly two-thirds of the states have moved to market-sourcing for all corporate receipts (TPP, services, and intangibles).

STATE OF ARIZONA

Department of Revenue



Comparison of SB1460 with House Engrossed HB2479

General framework of House Engrossed HB2479 (2018):	General framework of the SB1460 (2019):
<ul style="list-style-type: none"> • Adds definitions to A.R.S. § 42-5001 including: <ul style="list-style-type: none"> ○ Computer ○ computer software ○ computer software maintenance contract ○ prewritten computer software ○ remotely accessed ○ specified digital goods ○ specified digital services: <ul style="list-style-type: none"> ▪ (includes SAAS, PAAS, IAAS, application service providers, hosting services, colocation services, data storage management, data processing and information services, streaming services, digital authentication services, non-computing services) ○ transferred electronically 	<ul style="list-style-type: none"> • Does not add any new definition to A.R.S. § 42-5001 but definitions added to new A.R.S. § 42-5077
<ul style="list-style-type: none"> • A.R.S. § 42-5002 • Specifically states that digital goods and computer software can only be taxed as provided in the new classification(<ul style="list-style-type: none"> • A.R.S. § 42-5002 • Specifically states that digital goods and computer software can only be taxed as provided in the new classification
	<ul style="list-style-type: none"> • A.R.S. § 42-5010 • Includes the new digital goods classification in the rates/distribution statutes
<ul style="list-style-type: none"> • A.R.S. § 42-5040 • Sources gross receipts from prewritten computer software and specified digital goods to the seller's location in Arizona if the order is received at a business location in Arizona • Adds the customer's billing address to the sourcing statutes (whereby the customer's billing address is used in the absence of a delivery address. 	<ul style="list-style-type: none"> • A.R.S. § 42-5040 • Sources gross receipts from the sale/lease/license of software and digital goods to • the seller's location if seller receives order in state and software/digital goods are used in Arizona and • the purchaser's location if seller receives order at location outside Arizona but software/digital goods used in Arizona

<ul style="list-style-type: none"> • A.R.S. § 42-5061 • Specifically includes the taxation of prewritten software and specified digital goods transferred electronically as part of the retail classification. 	<ul style="list-style-type: none"> • A.R.S. § 42-5061 • Removes application services deduction from retail and rental classifications and includes it as deduction to new classification of digital goods
	<ul style="list-style-type: none"> • A.R.S. § 42-5075 • Makes technical changes to the prime contracting classification
	<p>New Classification</p> <ul style="list-style-type: none"> • A.R.S. § 42-5077 • Adds new digital goods classification • Classification comprised of the business of selling, leasing or licensing for use of computer software and digital goods • Tax base is the gross income derived from the business • Includes the following deductions: <ul style="list-style-type: none"> • Digital services • Sale/lease/license for re-sale/re-lease/re-license • Businesses that use software/digital goods as inconsequential elements • Services in addition to the sale/lease/license of software if optional (no requirement to separately state) • Application services • Certain retail deductions • Over the top services similar to cable programming but not including pay per view • Includes the following definitions: <ul style="list-style-type: none"> • Computer

	<ul style="list-style-type: none"> • computer software • computer software maintenance contract • digital services • prewritten computer software • specified digital goods
<ul style="list-style-type: none"> • A.R.S. § 42-5151 • Adds definitions for <i>use</i> tax purposes including: <ul style="list-style-type: none"> ○ <i>Taxpayer</i> to include vendors or users of prewritten software and specified digital goods transferred electronically where tax not paid ○ Adds definitions of the following by referring back to definitions in A.R.S. § 42-5001: <ul style="list-style-type: none"> ▪ Digital services ▪ Prewritten computer software ▪ Specified digital goods ▪ Transferred electronically • Amends the definition of “use or consumption” to include any right exercised over prewritten computer software or digital goods transferred electronically 	<ul style="list-style-type: none"> • A.R.S. § 42-5151 • Adds definitions for <i>use</i> tax purposes including: <ul style="list-style-type: none"> ○ <i>Taxpayer</i> to include vendors or users of prewritten software and specified digital where use tax not paid ○ Adds definitions of the following by referring back to definitions in the new classification: <ul style="list-style-type: none"> ▪ Digital services ▪ Prewritten computer software ▪ Specified digital goods • Amends the definition of “use or consumption” to include any right exercised over prewritten computer software or digital goods
<ul style="list-style-type: none"> • New use tax section A.R.S. § 42-5155.01 • Adds new section for <i>use</i> tax purposes of prewritten computer software and specified digital goods transferred electronically based on acquisition price • Liability of tax is on purchaser where software or digital goods transferred electronically purchased for resale but subsequently used • Tax rate is retail rate plus .6% (the add tax valid until June 30 2021) • Receipt with tax included from vendor with location in Arizona relieves purchaser from liability • Makes all use tax exemptions applicable 	<ul style="list-style-type: none"> • New use tax section A.R.S. § 42-5155.01 • Adds new section that levies use tax on the user or consumption of software and digital goods based on acquisition price • Liability of tax is on purchaser where software or digital good purchased for resale but subsequently used; does not apply if vendor is subject to TPT • Tax rate is retail rate plus .6% (the add tax valid until June 30 2041) • Receipt with tax included from vendor with location in Arizona relieves purchaser from liability • Specifies that all deductions under new classification applies to the use tax

<ul style="list-style-type: none"> • Requires each vendor with a location in Arizona to collect the tax unless the purchaser pays the tax directly to the department or if exemption applies • Specifies reporting requirements • Authorizes the department to extend the filing due date by three months • Appears to apply use tax to the selling, leasing or licensing for use 	<ul style="list-style-type: none"> • Requires each vendor with a location in Arizona to collect the tax unless the purchaser pays the tax directly to the department or if exemption applies • Authorizes the department to extend the filing due date by three months • Specifies reporting requirements • Appears to apply use tax to the selling, leasing or licensing for use
<ul style="list-style-type: none"> • A.R.S. § 42-5167 • Expands use tax direct payments to include reporting of the tax on prewritten software and digital goods transferred electronically 	<ul style="list-style-type: none"> • A.R.S. § 42-5167 • Expands use tax direct payments to include reporting of the tax on prewritten software and digital goods
<ul style="list-style-type: none"> • A.R.S. § 42-6015 • Permits municipalities to tax specified digital goods transferred electronically prewritten software regardless of method of delivery. • Specifically prohibits municipalities from taxing specified digital services or specified digital goods remotely accessed. • Specifically requires municipalities to source taxes on prewritten computer software and specified digital goods as provided in A.R.S. § 42-5040. 	<ul style="list-style-type: none"> • A.R.S. § 42-6017 • Permits municipalities to impose a tax on the sale, lease or licensing for use of prewritten computer software and digital goods only if they adopt the same terms as ARS 42-5077. • Prohibits municipalities from taxing digital services or on specified digital goods other than as provided in ARS 42-5077 <ul style="list-style-type: none"> • Specifically requires municipalities to source taxes on prewritten computer software and specified digital goods as provided in A.R.S. § 42-5040. • Makes definitions in A.R.S. § 42-5001 applicable.

Differences/similarities between the HB2479 and SB1460:

- Both have the same or similar definitions. SB1460 excludes the following definitions that were included in HB2479: remotely accessed, transferred electronically
- A major difference is the definition of digital services.
 - The HB2479 was very specific as to what was meant by digital services. Under HB2479 digital services was defined as cloud based or remotely accessed computing services and specifically included the following:

- Software as a service (SAAS),
 - platform as a service (PAAS),
 - Infrastructure as a service (IAAS),
 - application service providers,
 - hosting services,
 - data storage management,
 - data processing and information services,
 - streaming services,
 - digital authentication services ,
 - any noncompeting service of which the principal value is intangible in nature and
 - any other cloud based or remotely accessed computing service.
- SB1460 defines digital services as remotely accessed software or other services not specifically taxable under 42-5077; it will likely include everything that was specifically included in the definition of digital services in HB2479.
- HB2479 taxed digital goods and software under the retail classification; SB1460 creates a new classification but it appears that the new classification is structured like the retail classification since it includes several applicable retail deductions. The new classification includes leasing as well as licensing for use of software and digital goods.
- SB1460 exempts audio and video programming those services are sold as a package or are similar to the programming of a radio or television broadcast station; the exemption does not include pay per view programming or programs that are paid for separately. This was not included in HB2479, but was included in a proposed amendment to it.